EXECUTIVE SECRETARIAT

Routing Slip

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI				
3	EXDIR				
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8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/EEO				
14	D/Pers				
15	D/OEA				
16	C/PAD/OEA				
17	SA/IA				
18	AO/DCI				
19	C/IPD/OIS				
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SUSPENSE ____________
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Remarks: Copy to DD/OGI

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Executive Secretary

9/14/82

Date

3637 (10-81)

THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

DDI- 7356/82

DATE: 9/13/82 NUMBER: 077464CA DUE BY: -----

SUBJECT: CABINET COUNCIL ON ECONOMIC AFFAIRS -- September 14 Meeting

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
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	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☑	☐
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
Wheeler	☐	☑
Kudlow	☐	☑
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CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: Attached is the paper on legislative proposals to target interest rates, prepared by the Department of the Treasury, which was received by our office late this afternoon and is being circulated to you for tomorrow's meeting of the Cabinet Council on Cabinet Affairs.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☑ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

CM-292

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

September 13, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

From: Beryl W. Sprinkel

Subject: Legislative Proposals to Target Interest Rates

Bills have been introduced in both Houses of Congress (H.R. 6967 and S.2807) to require the Federal Reserve to set targets for interest rates. Both bills are entitled, "The Balanced Monetary Policy Act of 1982." The major difference is that under the House version, targets would be set annually for long-term, nominal interest rates while the Senate version specifies that targets be set for short-term, real interest rates that are positive and consistent with historical levels. A comparison of the major features of the two proposals is presented in the appendix.

Both bills are intended to "return predictability and stability to the financial markets, thus providing for lower, more stable real rates of interest" by ensuring "that monetary policy is conducted in a way which assures both economic growth and stable prices." The implication is that the policy of establishing a noninflationary rate of monetary expansion is causing high real rates of interest and impeding economic growth. The bills are written in language which would have the Federal Reserve temper its method of pursuing price stability.

The complication is that the intent of these bills is commendable, while the effect is potentially disastrous for the prospects of achieving stable, noninflationary economic growth. The rhetoric that accompanies these proposals is appealing -- the need for monetary policy to be more "balanced," and the need for the Federal Reserve and the Administration to recognize the hardship caused by high interest rates. Because of its populist appeal, the idea of interest rate targets has already gained considerable credibility.

However, the legislation is inconsistent with the goal of sustained noninflationary economic growth. If implemented, these proposals would raise significantly the cost of reducing inflation, at best, and would more likely preclude an effective anti-inflationary policy. Forcing the Federal Reserve to return to a policy of attempting to control interest rates would threaten more inflation The resulting monetary actions could well aggravate the current uncertainty in financial markets and intensify, rather than reduce, upward pressures on both nominal and real rates of interest.

The Fed strongly opposes these legislative proposals, fearing that these bills would fuel inflationary expectations and expose monetary policy to greater political pressure.

The Operational Difficulties of Attempting to Control Interest Rates

There are many significant operational problems associated with having the Federal Reserve try to control interest rates. The Senate bill, which would set targets in terms of short-term real rates of interest, suffers from many technical problems.

(1) There is no measure of real interest rates which is sufficiently precise to guide monetary actions

The real rate of interest is the difference between the market rate on a financial instrument and the expected rate of inflation over the future. There is no precise way to measure the expected inflation rate, and certainly no procedure which would provide an accurate guide for the short-term operations of the Federal Reserve.

The common practice of calculating the difference between a market rate and the current inflation rate provides a form of an ex post measure of real rates. But this method is accurate only if actual inflation turns out to be exactly what was expected. As long as inflation is imperfectly anticipated by investors, this conventional measure provides inaccurate information about the real rate of interest. In the current situation, for example, it is likely that expectations of inflation will continue to lag behind the actual slowing of inflation. Using current price changes as a proxy for the expected inflation will tend to exaggerate the level of real interest rates.

Even if these measurement problems are set aside (and most analysts casually do so), and it is assumed that this conventional calculation of real interest rates is useful, other difficulties remain. First, there is the problem of which index of inflation to use. Different measures of inflation yield very different results for the "real" interest rate. For example, comparing the Aaa corporate bond rate for 1980 to the inflation rate for the year yields a "real" interest rate of either +2.94% (very near the "historical average") or -1.56% depending on whether the GNP deflator or the CPI is used. If the Federal Reserve had been targeting real interest rates in 1980, should they have concluded that interest rates were right on target, or too low? Even more important for short-term control, it is not uncommon for different price indices to move in different directions over short periods of time; thus use of one price index would imply rising real rates while another index might imply falling real rates.

Second, the real interest rate that is determined by such a calculation is highly sensitive to the period of time over which inflation is measured. A one-month rate of change in the CPI, for example, would often imply a very different level for, and direction of change in, the real rate than, say, the change in the CPI over the past 6 or 12 months.

There is no neat "historical level" of real short-term rates

a real interest rate series -- the conventional, ex post measure -- is highly volatile and is influenced by a wide range of factors over which the Federal Reserve has no control. There is no "normal" real rate of interest unless there is credible price stability and having the Fed attempt to control a highly volatile series over which they have no effective control would surely not produce price stability.

In addition, data on price indices are available infrequently and with a considerable lag. Considering all these practical problems -- the inherent definitional problems, the lag in data availability, plus the fact that real interest rates (as typically measured) are highly volatile in the short run -- the conventional measure of real interest rates contains no useful information at all on which to base monetary policy actions.

(2) The Fed cannot "control" either nominal or real interest rates

Even if these measurement problems could be solved, however, real interest rates are not subject to manipulation by the actions of the Federal Reserve. Real interest rates are the result of the interaction of the expected productivity of capital and the public's preference for saving relative to consumption. The Fed has no direct, immediate control over either of these elements. Instead, current policy of monetary control is intended to remove the disruptive effect of inflation and uncertainty about inflation from these variables. That is the limit of the Fed's ability to influence the real costs of, and returns to, capital.

The trend of nominal long-term interest rates over the past 25 years has followed closely the trend of money growth, with a brief lag. There are several noteworthy aspects to this relationship. First, faster money growth is sufficient to guarantee higher rates of interest. Second, sustained slower money growth is necessary to achieve permanently lower interest rates.

-- despite a great deal of cyclical variability in money growth, the underlying trend through 1980 rose persistently;

-- prior periods of monetary restraint (1969, 1975-6) were brief and the upward trend was resumed;

-- the declines in long-term interest rates which followed decreases in the monetary trends were reversed as money growth accelerated;

-- these oscillations around a rising monetary trend seem to have put a rising floor under long-term rates of interest;

-- that floor reflects the expectations of inflation which accompany secularly expansive monetary policy;

-- the recent monetary restriction (1981-2) has yet to have a significant effect on the trend;

-- the relationship goes off track in 1980, as the long-term rate of interest rises sharply.

This last observation is the source of the current legislative proposals. The gap between the long-term rate and the trend of money growth -- a measure of the real rate of interest -- is unprecedented in recent history. The gap does not, however, appear to be due to "tight money." Instead, the evidence indicates uncertainty in credit markets as the culprit -- uncertainty which has resulted from the budget situation and volatile money growth.

(3) Attempting to control nominal interest rates is inconsistent with an effective, anti-inflationary monetary policy

Requiring that the Fed target real interest rates would lead unavoidably to their trying to control nominal interest rates. Given the definition and measurement problems associated with real interest rates the Fed would be forced into one of the following two procedures:

- Assume that the expected rate of inflation is fairly constant in the short run and therefore that real and nominal interest rates move in tandem. This is equivalent to targeting and controlling nominal interest rates.

- Assume that the expected rate of inflation equals some short-term changes in actual prices (i.e., assume future inflation is expected to match recent past inflation). For example, if the CPI increases at, say, a 6 percent rate for 6 months, then the Fed would be expected to achieve a nominal interest rate that is 6 percentage points above the target for the real rate.

In either case, the Fed's operations would be based on hitting a nominal interest rate target.

The lasting influence that the Fed has on interest rates is through the channel of inflation and inflationary expectations. The best contribution that the Federal Reserve can make to lower interest rates (real and nominal) is therefore to pursue an effective anti-inflationary policy. That requires slow, steady and predictable money growth.

The fundamental problem with setting targets for interest rates -- real or nominal -- is that attempting to control interest rates against the pressures of credit markets necessarily interferes with effective control of the money supply. Control of interest rates requires that the central bank be omniscient and omnipotent; that is, they must be capable of foreseeing and recognizing every market-induced change in interest rates, knowing why that change

occurred, and be capable of taking just the appropriate offsetting action.

Operationally, a procedure that attempts to control interest rates has an inherent inflationary bias. From 1970 to 1979 the Fed set very narrow targets for short-term interest rates, often less than +50 basis points from month to month. These targets were hit consistently. That procedure, however, generated a rising trend of interest rates, as money growth accelerated steadily in an effort to resist the market pressure on rates. More money meant accelerating inflation and expectation of inflation. The Fed abandoned explicit interest rate targets in 1979 for precisely this reason -- controlling inflation and focusing on interest rates are not consistent goals, particularly once inflation and inflationary expectations are present.

In addition, interest rate targets tend to aggravate procyclical monetary actions, aggravating variations in economic activity. As interest rates fall, however modestly, during periods of economic weakness, efforts to "lean against" the decline can cause an inappropriate restriction of money. Conversely, money would be pumped in when rates rise.

Adding interest rate targets to the existing targets for money growth, as both these bills propose, would add to the uncertainty and confusion that already surrounds monetary policy. The existence of multiple money growth targets itself is confusing and reduces the Fed's accountability; adding interest rate targets would only make a bad situation worse.

Any interest rate target set and publicly announced by the Federal Reserve would have great importance attached to it and could therefore have serious adverse effects on inflationary expectations. It is inevitable that interest rate targets will conflict with money growth targets. Given any inconsistency between the two sets of targets, there would be enormous pressure for the Fed to reduce interest rates to comply with their own targets. Thus, noninflationary money growth would probably be abandoned in an attempt to reduce interest rates. Anticipation of that eventuality could only fuel inflationary expectations, reduce the Fed's ability to achieve an interest rate target, and make the conflict between money and interest rate targets a self-fulfilling prophecy.

Summary

In sum, the proposed legislation to require the Federal Reserve to target interest rates (real or nominal) should be strongly opposed. The practice of targeting interest rates would endanger the program to control inflation. Moreover, it would not have the results that its advocates envision. Rather than generating lower interest rates to stimulate economic activity, the most likely outcome of controlling interest rates would be more inflation and greater uncertainty about monetary policy; both will cause interest rates to rise, not fall.

The political trick is to oppose the methods of this legislation without appearing to oppose its proclaimed goal -- lower and more stable interest rates. It must be made clear that while the Administration supports the intent of this legislation the proposed change in the Fed's operating procedure is not a path to lower interest rates. The path to lower, more stable interest rates is moderate, steady and predictable money growth; this is the policy that is already in place.

APPENDIX

Comparison of Major Features of S.2807 and H.R. 6967

-- H.R. 6967 defines "long-term interest rates," as the target and allows the Federal Reserve to determine the target level. S. 2807 does not give the Fed such discretion and defines targets as "positive real short-term interest rates, consistent with historical levels and with sustained economic growth and stable prices."

-- The House bill simply calls for long-term interest rate targets in addition to targets for monetary aggregates. The Senate version makes monetary targets secondary, that is, set so as to achieve the interest rate targets.

-- The House version allows the Fed to set a range around its monetary and interest rate targets, while the Senate bill would mandate the targets be "achieved, on average, on an annual basis."

-- Both versions would allow the Federal Reserve to deviate from the interest rate targets in response to "... rapidly accelerating inflation or high unemployment..." (emphasis added). Both versions would have the Federal Reserve announce such changes when they occur, and present justification to the Congress.

-- H.R. 6967 goes one step further, however, in mandating that the President offer the Administration position on "... each vote on monetary policy..." The bill states that this shall be for the Federal Reserve System's record, and thus it is not clear that the statement would be made public.